Adapted from: ***Risks and Rewards of Entrepreneurship*, EMC Publishing**

Just WHAT is PROFIT?

Understanding profit is essential to anyone interested in starting their own business. It is also important for anyone who works in a business that seeks to make a profit. Much of the misunderstanding about profit is related to a lack of understanding of the terms used in business that explain financial decisions.

For example, "***return on investment"*** means the percentage you make each year on the money you invest. If you put $10,000 in a savings account at the bank you will earn interest...probably around 5-6% per year. If you put that same $10,000 in stocks you will hope to earn dividends as well as have the value of the stock go up to give you a return on your investment. Now, if you invest that $10,000 in your business you will hope to be able to make even more as a return on your investment than just putting it in the bank. In that case you would expect to make an annual profit that is greater than about $500 (5% of $10,000). After all, the higher the risk the greater return the entrepreneur would expect for the investment.

Next we need to define ***"profit"***...or better yet what profit is not.

Profit is not included in the amount of money a business owner pays himself/herself. Many new entrepreneurs forget to count the costs of their time and take out a regular salary. Or when times are tough the salary is the first thing they forget.

Profit is not the difference between the costs of the product or service and the price being charged for it. In addition to the costs of the product sold you must account for the ***"fixed costs"*** that are paid regularly each month no matter what. These include such items as rent or mortgage payments, utilities, regular salaries, insurance, etc.

Next you must remember to plan for the ***"variable costs"*** of running the business that fluctuate with the success of the business and resulting needs for advertising, staffing, supplies, etc. The fixed costs and the variable costs together are known as ***"overhead".*** Overhead, as well as the costs of the products sold, is subtracted from the ***"income from sales***" before profit can be made.

Finally you must pay taxes out of the income before actually determining your profit from your business. These include ***"federal, state, and local taxes***" which are based on a percentage of your income minus expenses. After all these costs, ***the owners' profit is what is left***.

What are the decisions that affect profit?

For any small business there are many day-to-day decisions that change the possible profit the business might make. For example consider what each of the following choices might do to your profit:

* Pay employees more
* Hire more employees

* Buy new furniture
* Buy a new truck
* Find a cheaper source of products
* Increase the advertising budget
* Give your daughter money to buy a new dress
* Select a cheaper long distance phone service
* Remodel your building

All of these decisions increase, or decrease your cost of operations affecting what is left as profit.

When deciding how to price the goods or services to be sold, the owner must take into consideration the costs of all decisions made. Some decisions will result in higher sales which will more than make up for increased costs. It is thought that appropriate advertising will do this. Or if you pay your employees more they may be willing to work harder and increase sales. However, nothing is really sure about these decisions and their effect on profits.

So business owners often decide to use a percentage of the product costs in determining their selling prices. The percentage is based on distributing the costs of running the business (overhead) and profits in an equal manner to all items sold, based on the product costs. This is called "***markup"***. Think of markup as the share of the consumer's price that is necessary to run the business, plus what is left over as return on the owner's investment. The markup on all the products sold, added together, is designed to cover the costs of running the business and making a profit.

Business owners use past experience and experience of similar businesses to determine the expected overhead costs and profit they hope to make. This is called their ***"margin"...***the amount of money available after the costs of products sold are deducted from the income from sales. If your sales equal $1 million and your product costs are $200,000, your margin is $800,000. **Remember, this is not your profit.** We hope by now you can explain why this is so. If not, please read this article again.

Organize the class in small groups to discuss the following:

What is meant by "return on investment?" Discuss some examples of how people get a return on their investment.

Is it better for a business to increase prices of their products or reduce costs if they are not making a profit? What might happen if they reduced costs and also reduced product prices to the consumer?

What actions might a business take to reduce its costs?

What is the difference between "margin" and "profit"?

Why is a business owner cautious of hiring more employees even if the business is booming?

Think of a local business. What suggestions would you make to the owner that might improve his or her profit?